

**PROCEDURAL FTB – FROM AUDIT
TO LITIGATION
(TO HELL AND BACK – FTB
VERSION)**

**1999 California Tax Policy Conference
San Diego, California
November 8 – 10, 1999**

AUDIT PROCESS OVERVIEW

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AUDIT PROCESS OVERVIEW

A. When and Why Auditors Request Information

1. Role of the auditor. The auditor's role is to document the relevant facts, apply the tax law to that set of facts, and arrive at a conclusion concerning the accuracy of the tax return. Many state tax issues such as unity, business versus nonbusiness characterization, sales factor treatment, etc. are very fact intensive. An auditor needs to have a thorough understanding of many aspects of the taxpayer's business in order to properly evaluate those types of issues.
2. Factual development should be unbiased. FTB policy is for auditors to document all the facts relevant to a particular issue. The objective is to arrive at the correct tax treatment of the issue. This means that auditors should not limit their examination to the facts that they believe will be favorable to the state. Facts that support the taxpayer's position should be developed as well, or the taxpayer should be given the opportunity to submit those facts.
3. Information requests should be reasonable. If the taxpayer does not understand the relevance of a request, the auditor is responsible for explaining why the information is necessary. Auditors will also work with taxpayers to determine whether alternative information can be provided in lieu of the requested information if the taxpayer is unable to provide the specific items requested.

Many taxpayers are concerned about providing sensitive information such as corporate minutes. Copies of corporate minutes are often critical documentation for issues such as unity, and there may not be satisfactory alternative documentation. However, auditors can work with the taxpayer to minimize any concerns about releasing photocopies that the taxpayer may have. For example, if the auditor is provided with a copy of the minutes, the auditor can strike out the portions that are not germane to the issue under audit. The taxpayer can then review the redacted minutes to determine whether the remaining portion of the minutes being released to the auditor is acceptable. This type of cooperation on both sides can resolve most problems that arise during an audit.

4. Taxpayers and auditors should reach agreement as to the facts. Factual development should support the adjustments throughout the protest and appeal process. If the factual development at the audit level is not complete, additional facts may be introduced at the protest or appeal level to prove the NPA to be incorrect. Obviously it is more cost beneficial to both the taxpayer and the department if all the facts had been known at the audit level so that a protest would not have been necessary. For this reason, the department encourages auditors to obtain the taxpayer's agreement as to the *facts* even if the taxpayer does not agree with the auditor's *interpretation* of those facts.

5. Factual development is an audit function. It is not appropriate to bypass the audit function by withholding information that the auditor has requested with the expectation that the information can be provided at the protest level where the review may be more limited. To discourage that practice, the department will impose the failure to furnish information penalty when appropriate. Furthermore, when such cases are protested, they will be returned to the field auditor for completion of the factual development.

B. What Does it Take For an Audit to Run Smoothly?

1. Communication between the taxpayer and auditor is essential. The audit usually starts with an opening conference between the Tax Manager and the audit team where an understanding of the ground rules for the audit are established by both parties. The auditors should discuss the intended scope of the audit, including what material issues they are planning to address. Projected dates should be mutually established for important benchmarks during the audit process and for final completion of the audit. As the audit progresses, the audit plan may need to be modified. When this occurs, the auditor and taxpayer should discuss the progress of the case and re-establish benchmarks and target dates. As issues are completed, the auditor should discuss the audit conclusions with the taxpayer and provide the taxpayer with an Audit Issue Presentation Sheet which explains the amount of the adjustment, the facts and statutory basis for the adjustment. Through regular communication, misunderstandings and frustration on both sides can be kept to a minimum.
2. The department is encouraging single question information/document requests (IDRs). These are IDRs that contain only one question per IDR. When an IDR contains multiple requests, it can become difficult for both the taxpayer and the auditor to monitor responses. Single-issue IDRs also allow more flexibility in tailoring response times to the specific requests. Some requests may be quickly provided, while others require more preparation by the taxpayer. Tailoring the response times will allow the auditor to begin working with the information that can be quickly provided while the taxpayer is still gathering information to satisfy the remaining requests. This can greatly accelerate the time that it takes to complete an audit. Finally, many taxpayers find single question IDRs more convenient when going outside of the tax department to obtain responses.
3. Waivers to extend the statute of limitations. The department's goal is to complete audits within the normal four-year statute of limitations. Because of the complexity of large multistate audits however, there will be occasions when waivers of the statute of limitations become necessary. Waivers allow the auditor to provide the taxpayer reasonable extensions of time to respond to IDR requests. Waivers also insure that the auditor is able to complete the factual development of the case so that correct audit conclusions can be drawn. On the other hand, the auditor has a responsibility to make timely progress on the case. It is not acceptable for an auditor to place a case on a "back burner" for a lengthy period of time and then request a waiver to extend the statute of limitations.

The department requires auditors to submit cases for their supervisor's review at least six months before the statute of limitations is due to expire. This allows the auditor time to correct any problems identified during the review process. Waivers should therefore extend the statute of limitations for at least six months beyond the time that it takes to

complete the audit. Communication is important so that both parties are aware of the status of the case, the progress that is being made, and that benchmarks and completion dates that are being achieved.

4. When problems arise. Occasionally problems will occur between the taxpayer and auditor. Such problems should be brought to the attention of the audit supervisor. If not resolved at that level, the taxpayer should contact the program manager for assistance. Names and phone numbers of the program managers are listed in the attached exhibit.

C. Other Developments

1. The Review Process is evolving. The auditor's supervisor has the primary responsibility for reviewing the case and making sure that the audit conclusions are correct and fully supported. After completion, cases are sent to a Central Review unit for a final review to ensure that department policies are being consistently applied. Whereas in the past reviewers only saw the end product of an audit, reviewers are now frequently interacting with auditors as the case progresses. The obvious advantage of this is that any problems can be identified and corrected early in the audit, thus saving time and resources for both taxpayers and the department.
2. New Power of Attorney Database. In 1999, the department established a database to centralize information on the authority of taxpayer representatives. Powers of attorney received after the implementation of the new database will be accessible on-line to users throughout the department. This will facilitate the verification of a representative's authority, which will make it more convenient for taxpayers and their representatives to deal with the department.
3. Notices of Proposed Assessment (NPAs). When NPAs are issued the taxpayer has sixty days in which to file a protest. If a protest is filed, the assessment does not become final until after the protest is resolved and a Notice of Action is issued. Because audits usually involve multiple years, it is not uncommon for the audit to result in a proposed overassessment for one year and a deficiency for another year. If the proposed overassessment is related to the NPA issues, it will be held until the final resolution of the NPA, at which time it will be offset against the balance due with respect to the NPA.
4. FTB manuals will be available on the FTB Internet website. The manuals that will be available online include:
 - Apportionment Field Audit Manual
 - Bank & Financial Audit Handbook
 - Economic Development Area Manual
 - General Tax Audit Manual
 - Multistate Audit Technique Manual
 - Water's-Edge Manual
 - Exempt Organization Manual

Most of the manuals will be posted to the website by late 1999 or early 2000. Some of the manuals are in the process of being updated, and will be posted once the updates are completed.

D. How Current is the Audit Inventory?

1. We have made it a goal in the Multistate Audit Program to complete all audits within the normal four-year statute of limitations. Over the past several years we have made a significant improvement in becoming more current in our audit process and have taken some very dramatic initiatives to achieve this goal. We have performed limited scope audits on issues where necessary, reduced the audit process to two year increments in certain situations, and made it a policy to not open an audit if there is six months or less remaining on the statute of limitations unless certain conditions exist. The process of becoming current will not be accomplished overnight, but we have made a significant improvement over the past several years. The taxpayer community is asked to assist us in expediting the audit process by supplying requested information and responding in a timely fashion.

FTB MULTISTATE AUDIT MANAGERS

Director, MSA Out-of-State Field Offices.....	Mike Duffel	(516) 877-8623
Manager, MSA California Field Offices	Ed Romano	(916) 845-5666
Manager, Northern California	Frank Teran	(415) 904-6990
Manager, Southern California	Tom Kawasawa	(714) 567-6057
Manager, Chicago.....	Mary Schenk	(312) 759-4120
Manager, Houston	Paula Stroumpos	(713) 853-4621
Manager, Long Island	Desmond Prass	(516) 877-8605
Manager, Manhattan.....	Larry Berger	(212) 575-1536

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Topic Handout On:

**Administrative Protest Procedures
Appeals to the State Board of Equalization
FTB Administrative Settlement Program
Litigation Issues**

Presented by:

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PROCEDURAL FTB – FROM AUDIT TO LITIGATION

I. Administrative Protest Procedures

A. Introduction

A taxpayer may file a written protest against a proposed assessment by Franchise Tax Board, specifying the grounds upon which the protest is based, within 60 days after the mailing of a notice of a proposed deficiency assessment. (Rev. & Tax. Code §19041.) During the protest process, a member of the FTB staff acts as a hearing officer to reconsider the proposed deficiency assessment.

Protests are designated by the FTB as either docketed or undocketed. Compliance staff acts as hearing officers on protests designated as undocketed, and legal staff acts as hearing officers on protests designated as docketed. Protests involving large dollar amounts, complex legal issues, or issues of widespread interest in the taxpayer community are generally designated as docketed protests. Most cases involving multistate tax issues are designated as docketed protests.

The protest process often includes additional factual development of cases by means of information requests issued to taxpayers. Occasionally, protests are returned to the field for additional audit work. Taxpayers are entitled to an oral hearing on protests if requested. At the completion of the protest, FTB staff notifies the taxpayer of its action on the protest, which may include affirming the assessment, modifying it, or withdrawing the proposed deficiency. Formal Notices of Action on the protest are then issued.

B. Historical Background

The department's efforts to reduce protest processing times date back to enactment of the Katz-Harris Taxpayer Bill of Rights Act, Revenue and Taxation Code sections 21001-21027. In 1989 the Franchise Tax Board, together with the State Board of Equalization, the State Bar, the California Society of Certified Public Accountants, the Taxpayers' Rights Advocate, and others developed a plan to resolve protests within 38 months. However, because the time frames did not include many other FTB functions within the time guidelines; thus, completion of protests often takes longer.

C. FTB Notice 99-1

The Franchise Tax Board initiated new internal procedures earlier this year that were designed to reduce the length of time necessary to process protest cases. FTB Notice 99-1 (Appendix A), issued on March 3, 1999, advises the public of new internal policies and procedures at the FTB for the processing of protest cases. The goal of the new procedures is to reduce the time

necessary to evaluate the merits of protests pending before Board staff, conduct a hearing, and issue a Notice of Action, to 33 months or less from the filing date of the protest. Under procedures outlined in the Notice staff will do the following:

1. For protests filed before September 1, 1998, jointly arrange a case development plan with the taxpayer or its representative designed to accomplish all necessary factual development and conduct a requested hearing within a time sufficient to allow processing of protests within the 33-month target. Case development plans were to be in place by May 30, 1999.
2. For newly filed protests, make initial contact with the taxpayer or its representative within eight months of the date the protest is filed.
3. For cases already in development, initiate discussions on setting an agreed hearing date during the next substantive contact.
4. Unless it obtains management approval, staff will not consider issues not raised in the initial protest or within the 60-day limitation of Revenue and Taxation Code section 19041 unless such issues can be resolved within the 33-month target period.
5. The 33-month time period for the conclusion of protests does not include the following circumstances:
 - a) The file has been referred back to the field.
 - b) New issues are raised that were not raised in the original protest time frame, the new issues cannot be addressed within the 33-month time frame, and management has determined that it is appropriate to resolve the new issues at the protest level.
 - c) Cases where the same taxpayer has pending before the Board of Equalization or the courts another case involving different years and the same issues, or cases where another taxpayer has such cases before the Board of Equalization or the courts that will control with respect to the current protest. In such cases, deferral will normally be conditioned on an agreement that the other case is controlling.
 - d) Cases affected by the automatic stay under bankruptcy proceedings.
 - e) A dispute between the taxpayer and the Internal Revenue service is unresolved and essential to the determination of state tax liability.
 - f) The case has been referred to the FTB administrative settlement program.
 - g) The taxpayer has petitioned for relief under Revenue and Taxation Code section 25137.
 - h) The case has been referred to the Special Investigations Bureau.

Cases coming off deferred status will be given priority to the extent necessary to complete processing within the 33-month time period.

D. Proposed Regulations 19041 and 19044

In response to the Office of Administrative Law concluding that that FTB Publication 1037 constituted an underground regulation, proposed regulations 10941 and 10944 have been proposed to outline specific rights of taxpayers and provide information on how the department will handle protests and conduct oral hearings on protests. A public hearing on the proposed regulations was conducted on August 6, 1999, and the regulations were presented to the Franchise Tax Board on September 16, 1999. At that meeting the Board directed staff to hold a symposium to obtain public input on the proposed regulations. The symposium will be scheduled in the near future. Progress of the proposed regulations and notice of the symposium may be obtained on the FTB website at www.ftb.ca.gov.

Highlights of proposed Title 18, California Code of Regulations, section 19041 as currently constituted include:

1. A protest is timely filed if mailed to the department within 60 days of the Notice of Proposed Assessment. The date of mailing of the Notice is presumed to be the date on the Notice. The presumption may be rebutted if the postmark on the envelope is a different date.
2. A protest is filed by mailing it to the address on the reverse side of the Notice.
3. A protest must be in writing, dated, and must indicate that a protest is being made of the proposed deficiency assessment reflected in a Notice.
4. The protest must contain the name, identifying number(s) current address of the taxpayer, the current address of the taxpayer's representative, if any, the amounts protested, the years to which the protest is directed, the issue number of the Notices protested, and the date of the Notice protested. If a taxpayer contends that a Notice was mailed on a different date than the date of the Notice, the protest must set forth the basis for such an assertion.
5. A request for an oral hearing must be included in the original protest. The department will have discretion to grant a hearing if requested later.
6. A protest must be signed by the taxpayer or an authorized representative.
7. Protests may be made on any grounds, including those not set forth in the Notice of Proposed Assessment. The protest shall set forth the grounds on which it is based, and the factual and legal basis for the assertion of error.

8. Protests are limited to the grounds set forth in the original protest. The department has discretion, which shall be liberally construed, to allow a taxpayer to present new grounds consistent with efficient and timely tax administration.
9. Protests that are not complete are not valid. Missing information may be submitted within 60 days of the protest, or upon such extension as may be granted by the department. The department may request perfection of a protest. If requested, information must be provided within 30 days of the request.
10. The department may request additional information regarding the grounds raised in the protest. The taxpayer must provide a timely and complete response to the request. A failure to respond may give rise to an assertion against the taxpayer that it has failed to exhaust its administrative remedies.
11. The department will issue a determination letter setting forth the basis of its protest determination. The taxpayer will be allowed a reasonable time to respond

Proposed Title 18, California Code of Regulations, section 19044 focuses on the requesting, locating, scheduling, and conducting hearings.

1. The department shall grant a request for an oral hearing where it requests additional information and the request is made before the time of response to the information request.
2. Where possible, the location and time of the hearing are set by mutual agreement.
3. An oral hearing may be conducted by telephone, videoconference, or similar means at the taxpayer's request.
4. Oral hearings may be rescheduled once at the request of the taxpayer or at the discretion of the department.
5. Language assistance may be provided if requested.
6. A taxpayer is entitled to representation at the hearing if it desires.
7. Hearings are to be conducted informally. If the department wishes to record a hearing, it shall notify the taxpayer at least one week in advance of the hearing and provide a copy to the taxpayer if requested.
8. Procedures for the taking of testimony and documentary evidence are specified in the proposed regulations.
9. Additional information may be requested at the hearing.

See Coffill, *FTB's Proposed Regulations Receive Cool Reception at Public Hearing*, 10 State Tax Notes 627, September 6, 1999 (Appendix C) for a discussion of concerns regarding the proposed regulations.

II. Appeals to the State Board of Equalization

Income or franchise tax matters pending before the State Board of Equalization are governed by the provisions of Title 18, California Code of Regulations, sections 5010 et seq., which outline in detail the procedures for the conduct of appeals. Items such as calendaring are under the control of the staff of the State Board of Equalization. Thus, although the FTB may not oppose, or may even agree with, a calendar request by the taxpayer, such requests should be directed to the Board Proceedings Division of the Board of Equalization.

III. FTB Settlement Procedures

FTB Notice 99-11 (Appendix D), July 13, 1998, updates revises, and supercedes prior Notices outlining settlement procedures. The Notice outlines the requirements of a valid request to enter the settlement program. Taxpayers wishing to initiate settlement of civil tax matters should send a written request to the Settlement Bureau Director containing:

1. The taxpayer's and representative's names and addresses.
2. The taxpayer's identification number, the years involved, and the present status of the dispute.
3. A copy of the representative's power of attorney.
4. A good faith settlement offer, including the factual and legal grounds in support of the offer.

Income or franchise tax appeals are not be deferred by the FTB pending a review of a settlement request. Taxpayers desiring to enter the settlement program should send a request as soon as possible as outlined in FTB Notice 98-11. If accepted for settlement, appeals are deferred for up to nine months pending settlement efforts.

IV. Litigation Issues

In *Agnew v. State Board of Equalization* (1999) 21 Cal.4th 310 [87 Cal.Rptr.2d 423, 981 P.2d 52] (Appendix E), the taxpayer brought a declaratory relief action seeking a declaration that Board's requirement that a taxpayer pay tax and accrued interest prior to making a valid refund claim or initiating litigation seeking a refund of taxes was not supported by Article XIII, section 32 of the California Constitution or any statute.

As a procedural prerequisite, the Supreme Court held that the declaratory relief action did not constitute an "injunction or writ of mandate or other legal or equitable process . . . to prevent or

enjoin the collection . . . of any tax or any amount of tax required to be collected" under Revenue and Taxation Code section 6931, because the taxpayer did not seek any determination of the validity of the tax assessed against him.

The court held that Article XIII, section 32 and its predecessors did not operate to bar claims for refund or litigation when the taxpayer has paid the disputed tax but not accrued interest on a the tax delinquency. The rationale of the Supreme Court's decision appears to apply to claims for refund or litigation for the refund of franchise or income taxes as well. It is anticipated that the FTB will be issuing formal guidance on this issue in the near future.